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RUEHRC/USDA FAS WASHDC 4215
RUEHBUL/AMEMBASSY KABUL 8615
RUEHDO/AMEMBASSY DOHA 1539
RUEHNE/AMEMBASSY NEW DELHI 3282
RUEHKP/AMCONSUL KARACHI 9764
RUEHLH/AMCONSUL LAHORE 5503
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UNCLAS SECTION 01 OF 03 ISLAMABAD 001953

SENSITIVE

SIPDIS

E.O. 12958: N/A
TAGS: EFIN ETRD ECON PREL PK
SUBJECT: STATE BANK OF PAKISTAN ANNOUNCES TIGHTER
MONETARY POLICY; STOCK MARKET SUFFERS SHARP LOSSES

Summary

¶1. (U) Summary: The State Bank of Pakistan Governor Dr. Shamshad Akhtar announced a series of measures to tighten monetary policy, drain excessive liquidity from the system, and decrease imports to firm up the rupee in a May 22 speech. Most of the new measures, which are effective immediately, are designed to stem further increases in the current account and fiscal deficits and to rein in inflation. These measures include: a requirement that importers put a 35 percent down payment to open letters of credit (except for food and oil imports), a 150 basis point (1.5 percent) increase in discount rate to 12 percent, and a 100 basis point (one percent) hike in the statutory liquidity ratio and cash reserve requirement to 19 and 9 percent respectively. In addition, all banks must pay five percent interest on savings deposits beginning June 1. The Karachi Stock Exchange KSE-100 index lost 615.26 points on May 23, its second largest decline. End Summary.

SBP tightens monetary policy again
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¶2. (SBU) State Bank of Pakistan (SBP) Governor Dr. Shamshad Akhtar announced a series of measures to further tighten monetary policy in a May 22 speech. The SBP normally issues monetary policy statements twice a year, in January and in July. However, the widening current account and fiscal deficits, soaring food inflation, and steady depreciation of the rupee forced the SBP to act in advance of formulation of the new budget. The SBP hopes that these new measures will slow inflation, reduce aggregate demand, and stabilize the exchange rate.

¶3. (U) The new measures include:

-- a 150 basis point (1.5 percent) increase in the SBP's discount rate to 12 percent effective May 23, 2008;
-- an increase in the Cash Reserve Requirement (CRR) for all deposits up to one year maturity by 100 basis points (one percent) to 9.0 percent;
-- maintaining the CRR for deposits of over one year maturity unchanged at zero percent;
-- an increase in the Statutory Liquidity Requirement by 100 basis points (one percent) to 19 percent of the total time and demand liabilities; and
-- imposition of 35 percent letter of credit cash margin on all

imports except for oil and food. (Note: Previously importers could open a letter of credit with no cash down. End note.)

Banks Required to Pay Higher Rates on Deposits
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¶4. (SBU) In an effort to encourage savings deposits, the SBP will require that all banks pay a minimum five percent interest rate on savings products effective June 1. Savings deposits constitute 63 percent of the total number of countrywide deposit accounts. The interest rate for saving accounts was 2.1 percent. (Comment: The real interest rate for savings will still remain negative due to the increasing inflation rate. Pakistan has very few profitable savings vehicles for individuals unwilling to risk the stock market. End comment.)

Current account deficit unsustainable
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¶5. (SBU) The SBP projects the current account deficit in the range of 7.3 - 7.8 percent of GDP, which is much higher than the initial projection of 5 percent for FY08. The rising current account deficit indicates that, despite decent export performance, significant import demand pressures still exist. Oil, food and textile inputs account for 43.4 percent of imports, and international prices for these commodities have been increasing steadily. Agricultural inputs represent another 15 percent, and machinery exports account for 16.3 percent of imports. (Comment: Press reports frequently blame the current account deficit on "luxury imports." Since the majority of Pakistan's imports are food, fuel, inputs, or machinery,

there appears to be little justification for this argument. End comment.)

Drop in foreign inflows
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¶6. (SBU) The GOP assumed growth in foreign exchange inflows when it made its FY08 balance of payments projections, given FY07's positive results. However, liquidity constraints in global financial markets and the domestic political uncertainty have negatively impacted net foreign inflows. The growing external current account deficit along with slowdown in foreign direct investment and foreign portfolio outflows has resulted in drawdown of reserves by USD 3.7 billion from July 1 - May 16.

KSE-100 loses 615 points
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¶7. (SBU) The Karachi Stock Exchange KSE-100 lost 615.26 points to close at 13,011.74 on May 23. This was the second largest KSE decline. Market capitalization declined by USD 2.7 billion. Market volumes were also down, with 154.75 million shares traded on May 23, compared to 191.5 million May 22. The KSE-100 index lost 1221.15 points during the week of May 19-23. Analysts ascribed the near record losses to the SBP's measures to decrease liquidity and continued political uncertainty.

Exchange rate depreciates significantly
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¶8. (SBU) Decreasing foreign inflows combined with speculation in the foreign exchange market have led to the rupee's 14.9 percent depreciation from July 2007 to date. Since April 1, the rupee has depreciated by over 11 percent. According to the SBP, tighter monetary policy and structural changes to limit the GOP's ability to use the Central Bank to fund its fiscal deficit should help stem the rupee's decline.

¶9. (SBU) Pakistan's budget deficit is projected to be significantly higher than the original FY08 budgetary estimates. By December 2007 (latest available data), the budget deficit had grown to USD 5.1 billion (Rs356 billion), nearly the entire full year USD 5.7 billion (Rs399 billion) target. The stock of outstanding GOP treasury bills, an instrument through which government borrows from SBP, has reached

USD 13.66 billion (Rs945.9 billion), or almost 9.4 percent of GDP). This is the highest level in Pakistan's 60 year history, and is more than double last year's level of USD 6.53 billion (Rs452.1 billion). As a result, the SBP's efforts to manage monetary policy have been made more difficult.

Inflation doubles
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¶10. (SBU) Overall inflation has almost doubled in last four months, rising from 8.8 percent in December 2007 to 17.2 percent in April
¶2008. More disturbing is the increase in food inflation, which rose to 25.5 percent from 12.2 percent during the same period. Non-food, non-energy inflation has jumped from 7.2 percent in December 2007 to 10.8 percent in April 2008. The SBP expects inflation at over 11.0 percent for FY08, substantially higher than its FY08 target of 6.5 percent.

Amend the Fiscal Responsibility Law
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¶11. (SBU) The State Bank has advised the government to amend the Fiscal Responsibility and Debt Limitation Act 2005 to incorporate appropriate provisions to limit the GOP's ability to borrow from the SBP. The GOP has continued to borrow from the central bank outside this legislation, eroding fiscal discipline and making it difficult to effectively tighten monetary policy. In FY08, the SBP has financed approximately 80 percent of the GOP fiscal deficit.

Comment

¶12. (SBU) Comment: The GOP faces a dilemma to preserve growth, attract continued foreign inflows, and close its fiscal and current account deficits. The SBP is trying to do its part, but its new measures are likely to have little impact if the GOP does not impose fiscal discipline in the new budget. Past efforts at tightening monetary policy -- as recently as the January 2008 1.5 percent interest rate increase -- have been undercut by the GOP's inability to rein in spending and continued increases in international commodity prices. Until Pakistan can implement significant energy saving measures or bring on-line new energy sources, its fuel import bill will continue to rise. The GOP's ability to continue to phase out energy subsidies will be key to resolving its fiscal woes, but is likely to cut growth. The new budget, which should be released in early June, will be key to answering how Pakistan plans to resolve its growing economic problems. End comment.

PATTERSON